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Legend:

Fund 1 =

Fund 2 =

Fund 3 =

Trust =

State =

Advisor =

Dear :

This responds to your request for a ruling dated November 20, 2009, and supplemental correspondence dated April 22, 2010, and July 14, 2010, submitted on behalf of Fund 1, Fund 2, and Fund 3 (each a "Fund," collectively, "Funds"). Funds request a ruling that income from certain derivative instruments will be qualifying income under section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code").

FACTS

Trust is a State business trust registered as an open-end management investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et

seq., as amended (the “1940 Act”). Trust is a series company under Rule 18f-2 of the 1940 Act and Funds presently are its only outstanding series or funds. Funds represent that they are investment companies registered under the 1940 Act, are classified as corporations for U.S. federal income tax purposes, and are operated in a manner intended to qualify them as regulated investment companies (RICs) under subchapter M of the Code. Funds are advised by Advisor.

Funds invest in equity securities of domestic or international companies. Funds intend to enter into swaps on securities or securities indices both to manage price risk with respect to the equity securities in their portfolios and as an alternative investment to direct ownership of the underlying securities.

Funds also plan to enter into certain derivative financial transactions to manage on a portfolio-wide basis the effects of inflation on the values of securities within their portfolios. These derivatives include interest rate swaps, constant maturity swaps, and Consumer Price Index swaps, collectively referred to herein as the “Swaps.”

In an interest rate swap, a Fund will enter into an agreement with a counterparty to exchange periodic payments based on an agreed-upon periodic interest rate multiplied by a notional principal amount. For example, in a “plain vanilla” interest rate swap, a Fund may make periodic payments based on a floating rate and may receive payments based on a fixed rate, or vice versa. In a constant maturity swap (CMS), a Fund makes periodic payments based on a short-term floating interest rate in exchange for payments based on a constant maturity rate (e.g., a five year interest rate). A CMS swap permits a Fund to execute a trade which references the actual interest rate in a certain number of years. A Consumer Price Index swap references the Consumer Price Index (CPI), which is a measure for estimating inflation by referencing changes in the price levels of a standard basket of goods. Because inflation equates to a diminished value of a currency, a CPI swap may be entered into in order to manage the effect of inflation upon the value of the portfolio.

LAW AND ANALYSIS

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the “qualifying income requirement”). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources.

Prior to the enactment of the Tax Reform Act of 1986 (the “1986 Act”), section 851(b)(2) identified qualifying income as “dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities.” Section 851 did not contain its own definition of the term “securities,” but section 851(c)(5) provided that, for purposes of the asset test, “all

other terms shall have the same meaning as when used” in the 1940 Act.

The 1986 Act expanded the definition of RIC qualifying income in a number of ways: by adding a cross-reference to the definition of “securities” in the 1940 Act; by adding gains from the sale or other disposition of foreign currencies; and by adding an “other income” provision. As so amended, section 851(b)(2) defines qualifying income, in relevant part, as—

dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in [the 1940 Act]) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [the RIC's] business of investing in such stock, securities, or currencies

Section 2(a)(36) of the 1940 Act defines the term “security” as—

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The Swaps entered into by Funds are not stock, debt instruments, or currency (or options, futures, or forward contracts with respect to stock, debt instruments, or currency). A swap is not specifically enumerated as a security in section 2(a)(36) of the 1940 Act, and there is no conclusive authority that interprets this definitional provision to include a swap. Rev. Rul. 2006-1, 2006-1 C.B. 261, 262, as clarified by Rev. Rul. 2006-31, 2006-1 C.B. 1133. Nevertheless, under section 851(b)(2), Funds’ income from the Swaps may be “other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [Funds’] business of investing in such stock, securities, or currencies” (hereinafter, “other income”) if the Swaps are securities for purposes of section 851(b)(2). Id.

The Securities and Exchange Commission (SEC) generally interprets the securities laws under the 1940 Act broadly so as to effectuate Congress’ purpose of

protecting investors by bringing many types of financial instruments under the SEC's review and regulation. In contrast, in determining whether a financial instrument is a security for purposes of section 851(b)(2), the Service applies principles of tax law, including those of subchapter M of the Code and accompanying legislative history, to analyze a financial instrument that is not specifically enumerated as a security under the 1940 Act.

In the case of a derivative instrument, this analysis takes into account several factors, including, but not limited to, the following: (1) the nature of the derivative's underlying referent; (2) the tax principles and the Congressional intent underlying the enactment and amendment of subchapter M of the Code, including the effects of the 1986 amendments to section 851(b)(2), which added the "other income" provision and the cross-reference to the definition of securities in the 1940 Act; and (3) the extent to which a RIC generates income and gain from the derivative that is passive in nature and akin to the passive income that the RIC generates from securities enumerated as such under the 1940 Act.

Underlying referent

Rev. Rul. 2006-1 addresses a derivative instrument whose value is based on the performance of a commodities index. Neither the derivative under discussion in that ruling nor its underlying commodities index is a specifically enumerated security within the definition of a "security" under the 1940 Act. The revenue ruling explains, however, that it is nevertheless appropriate to examine whether the commodities derivative is a security for purposes of section 851(b)(2) by considering the effect of the 1986 Amendment to that section and its accompanying legislative history. The revenue ruling concludes that:

A construction of the term "securities" that excludes derivative contracts providing for a total return exposure to a commodity index is consistent with Congress' intent in amending section 851(b)(2) in 1986. Accordingly, because the underlying property is a commodity (or commodity index), the Derivatives that *R* enters into are not securities for purposes of section 851(b)(2).

In this case, as in Rev. Rul. 2006-1, neither the Swaps nor their underlying referents are specifically enumerated in the 1940 Act definition of a security. Congress has consistently excluded commodities from the definition of a security and, as a result, Rev. Rul. 2006-1 appropriately concludes that a derivative contract on a commodities index does not produce qualifying income. The underlying referents for the Swaps at issue in this ruling are interest rates and the CPI. Although the CPI includes the value of certain baskets of commodities in measuring the average change in prices over time of goods and services of households, the annual percentage change of the CPI is predominantly used as a measure of inflation. Thus, unlike the derivative discussed in

Rev. Rul. 2006-1, an investment in a derivative referencing the CPI is not predominantly an indirect investment in commodities.

Congressional intent

In concluding that the commodities derivative in question was not a security for purposes of section 851(b)(2), Rev. Rul. 2006-1 explains that Congress did not intend the cross-reference to the 1940 Act to incorporate into section 851(b)(2) an expansive construction of the term “securities.” Id. at 264. Congress’ 1986 addition of the other income clause to section 851(b)(2) served a specific purpose, which was to expand the statutory description of qualifying income to include the types of income that the Service, in specific cases, had already treated administratively as qualifying income.

Income upon which the Service had specifically ruled favorably before the 1986 amendments included income from certain derivative contracts on stocks and securities (as the term “security” is generally understood in the U.S. tax law), such as futures and options on stock indices, which create an economic exposure to stock or securities even though the derivative’s underlying referent may be a collection of stocks and securities, rather than a specific stock or security. Also within this category was the receipt of “recovery” income, such as recovery of excess management fees, recovery of damages, and recovery of state taxes. 132 Cong. Rec. 4045, 4047-8 (1986) (remarks of Senator Armstrong, inserting letter of J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), dated February 5, 1986, to Rep. Flippo). In the recovery cases, the RIC receives reimbursements of income directly or indirectly generated from investments in stock, securities, or currencies. Id.

Prior to the enactment of the “other income” clause, the Service held that exchange traded futures contracts on United States Government securities, futures contracts on financial instruments, futures on domestic and Eurodollar certificates of deposit (CDs), and other interest rate contracts are section 851(b)(2) securities. Their pricing and economics make the Swaps at issue akin to the instruments that the Service has previously determined to be section 851(b)(2) securities.

Passive nature of income

Congress has explained that the favorable RIC tax provisions are intended for passive investment entities not engaged in active business and that a RIC’s investments should be limited to income from stocks and securities, as opposed to other property. Mr. Mentz’s letter, cited above, explained the fundamental policy served by the qualifying income requirement:

First, income qualifying under section 851(b)(2) should be limited to income from property held for investment, as opposed to property held for sale to customers in the ordinary course of business. Second, income

qualifying under section 851(b)(2) should be limited to income from stocks and securities, as opposed to other property. . . . For example, under the second limit, we would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment.

Id. at 4048.

The trading of portfolio securities is treated for federal income tax purposes as less active than other comparable business activities and produces qualifying income. Id. at 4047. Funds generate income and gain from investments in interest rate swaps, CMS swaps and CPI swaps that is equally passive in nature to that generated from investments in other section 851(b)(2) securities. Like an investment in Treasury Inflation Protected Securities (TIPS) (the principal of which increases with inflation and decreases with deflation, as measured by the CPI), Funds utilize a CPI swap to capture inflation accrual and not as a surrogate for investment in active trading in commodities or other goods and services. A plain vanilla interest rate swap, in which one party pays a fixed rate and the counterparty makes payments based on LIBOR, is priced with reference to the price of Eurodollar futures CDs. Although an interest rate futures contract on Eurodollar CDs and a plain vanilla interest rate swap are distinct financial instruments, Funds generate income from both investments that is equally passive in nature.

CONCLUSION

We rule that the Swaps described in this letter are securities for purposes of section 851(b)(2) and, accordingly, that income generated by Funds' investments in the Swaps is "other income" that is qualifying income under section 851(b)(2).

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the transactions described above under any other provisions of the Code and regulations. In particular, no opinion is expressed concerning whether the Funds otherwise qualify as RICs under subchapter M, part I of the Code.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Susan Thompson Baker
Susan Thompson Baker
Senior Technician Reviewer, Branch 2
Office of the Associate Chief Counsel
(Financial Institutions & Products)